

# Cross-country Differences in Unemployment: Fiscal Policy, Unions, and Household Preferences in General Equilibrium\*

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## Abstract

We develop a five period overlapping generations model with individuals who differ by ability and with an imperfect labour market (union wage setting) for the individuals of lower ability. The model explains human capital formation, hours worked and unemployment within one coherent framework. Its predictions match the differences in the unemployment rate across 12 OECD countries remarkably well. A Shapley decomposition of these differences reveals an almost equal role for fiscal policy variables and union preferences. As to fiscal policy, differences in unemployment benefits play a much more important role than tax differences. Differences in households' taste for leisure are unimportant.

*Keywords:* skill-type heterogeneity, union preferences, wage setting, overlapping generations, Shapley decomposition

*JEL classification:* E24, E62, J51, J64

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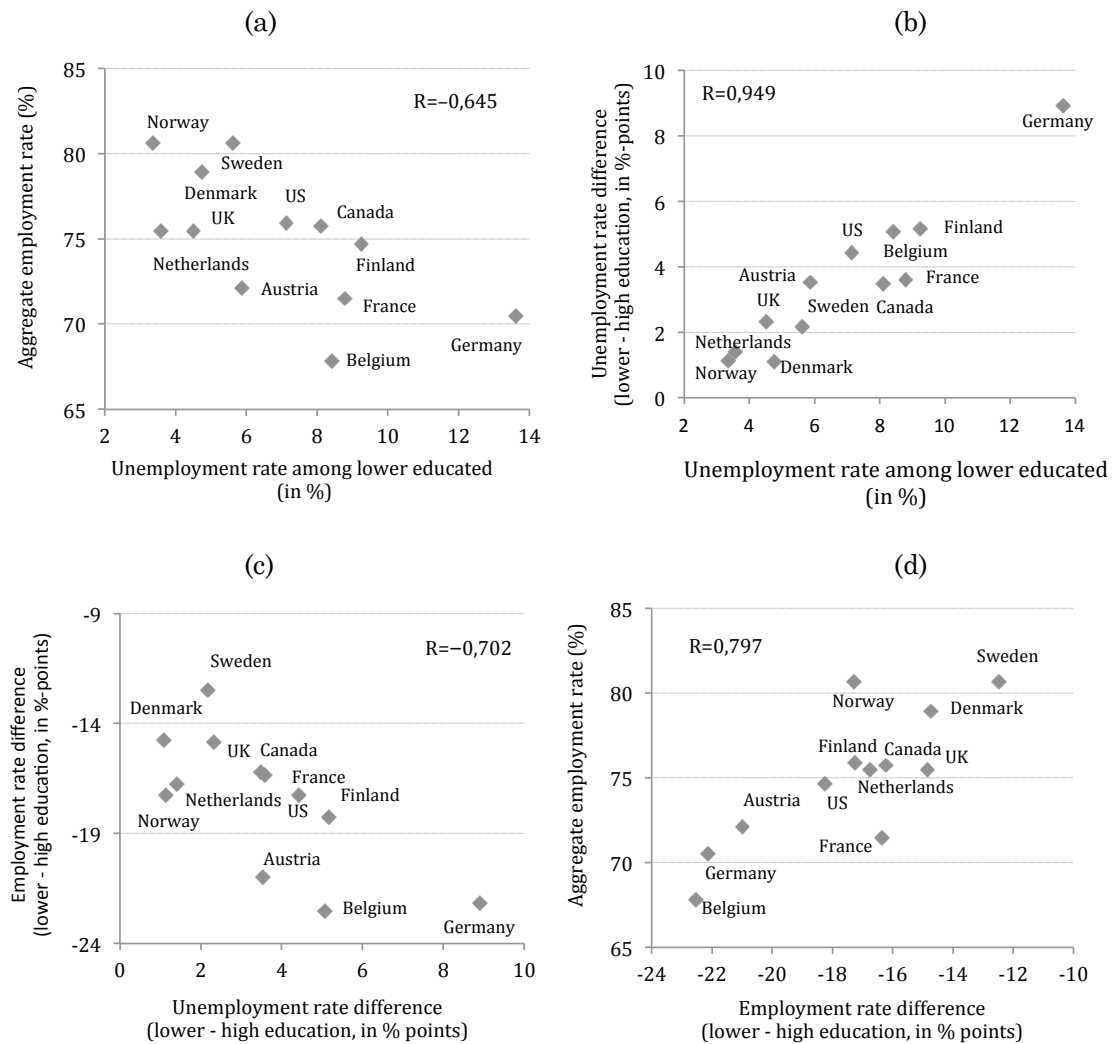
# I. Introduction

Labour market performance differs widely across OECD countries. Since about a decade many researchers have built gradually richer general equilibrium models to account for these differences. Initial contributions by Prescott (2004), Rogerson (2007), Dhont and Heylen (2008) and Ohanian *et al.* (2008) tried to explain differences in aggregate per capita hours worked. Later work introduced a life-cycle dimension in labour supply and employment in order to explain also the huge cross-country differences in employment among persons older than 50 (Rogerson and Wallenius, 2009; Erosa *et al.*, 2012; Alonso-Ortiz, 2014). Another advantage of introducing a life-cycle dimension is that it became possible to model the time allocation of young people between labour and education, and to explain human capital formation as an endogenous variable (Ludwig *et al.*, 2012; Heylen and Van de Kerckhove, 2013; Wallenius, 2013).

Despite the enormous progress that has been made in this literature, one clear weakness has not been dealt with. A striking observation in all the aforementioned models is their assumption of a perfectly competitive labour market. They cannot explain equilibrium unemployment, let alone the huge and persistent differences in unemployment between for example high and lower educated individuals. Yet, as demonstrated in Figure 1 for 12 OECD countries in 2001-2007, cross-country differences in aggregate employment are strongly related to differences in unemployment, in particular unemployment among lower educated individuals<sup>1</sup>. In panel (a), we observe the highest aggregate employment rates in countries like Denmark, Norway and Sweden that are relatively successful in avoiding unemployment among lower educated individuals. By contrast, countries that fail in fighting unemployment among the lower educated, like Belgium and Germany, also show relatively bad aggregate employment performance. The other panels in Figure 1 reveal a number of interesting other regularities, which will guide us later in this paper. Panel (b) establishes the fact that almost all cross-country variation in the gap between the unemployment rates of lower and high educated individuals is due to variation in the unemployment rate among the lower educated. Correlation in this panel is almost 0.95. Countries vary much less when it comes to the labour market situation of the high edu-

<sup>1</sup>We focus on 2001-2007 as this was the last period of relative stability on the labour market before the financial crisis and the euro crisis. To study equilibrium unemployment, it is clearly more appropriate to use data for a relatively stable period.

Fig. 1. Employment and unemployment in OECD countries, 2001-07.



**Notes:** We compute the (un)employment rate among lower educated individuals as the average of the (un)employment rates among individuals with less than upper secondary education and among individuals with upper secondary, but no tertiary degree. The (un)employment rate among individuals with higher education relates to those with a tertiary degree. Unless defined differently, all reported employment and unemployment rates concern the age group 25-64. The employment rate indicates the fraction of individuals who have a job. Data sources: Eurostat (LFS series: lfsa\_ergaed, lfsa\_urgaed) and OECD Labour Force Statistics (Total Employment).

cated. (Correlation between the unemployment rate among individuals with a tertiary degree and the unemployment gap between the lower and the high educated is only 0.14). Panel (c) shows a strong inverse relationship between the unemployment gap and the employment gap between lower and high educated individuals. Finally, panel (d) reveals that the aggregate employment rate is strongly related to this employment gap. We conclude that if it is the objective of countries to raise aggregate employment, an important challenge will be to fight unemployment among lower educated individuals. The existing (dynamic) general equilibrium models for labour market analysis in the tradition of Prescott (2004) and Rogerson (2007) have no clear

answer to deal with this challenge.

Next to excluding a potential role for labour market imperfections, the above mentioned general equilibrium literature also leaves little room for differences in individual preferences across countries to show up. Blanchard (2004) and Alesina *et al.* (2005) have argued that a key factor behind the lower employment in many European countries compared to the US is a higher taste for leisure. Yet, the general equilibrium literature generally imposes the same preferences upon individuals.

Our contribution in this paper is to extend the dynamic general equilibrium literature studying employment with a labour market imperfection and use our extended model to quantitatively explore which variables drive cross-country differences in unemployment, in particular unemployment among lower educated individuals. More precisely, we develop a five generations OLG model for a small open economy with two key assumptions. The first one - given the importance of skills and education - is the assumption that individuals are heterogeneous by ability. They enter our model with different human capital stocks and have different capacity to build more human capital. This approach may offer the best match to findings by Huggett *et al.* (2006), Huggett *et al.* (2011) and Keane and Wolpin (1997) that heterogeneity in human capital endowment at young age and in learning abilities, rather than shocks to human capital, account for most of the variation in lifetime utility. Our second assumption and key novelty compared to previous work in this tradition is the assumption of a unionized labour market for lower ability (lower educated) individuals<sup>2</sup>. Like Faia and Rossi (2013), we introduce a monopolistic firm-specific trade union that determines the real pre-tax wage for these workers while taking aggregate variables and fiscal policy parameters (e.g. tax rates, unemployment benefits) as given. We specify a Stone-Geary utility function for the union with both wages and employment as arguments, albeit with a different weight. As to wages, the firm-specific union only derives utility from the difference between the after-tax wage and a reference wage. The monopoly union chooses the wage in a first stage. In the next stage, the firm will choose

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<sup>2</sup>For higher ability workers we assume that wages and employment are determined in a perfectly competitive way. Several authors have provided empirical evidence that the effects of the presence of unions are much stronger for low skilled individuals than for the high skilled, e.g. through a higher union-non union wage premium among the low skilled workers. See e.g. Card *et al.* (2004), and Checci and García-Peñalosa (2008).

employment (number of workers), while the households of lower ability individuals decide on the supply of hours per employed. Both the firm and the households take the wage set by the union as given.

The union wage setting framework in our model is motivated by the observation that in Europe union wage bargaining is still the most common way of wage determination. While union membership rates have decreased over time, the coverage of collective bargaining is still at least 80% in most continental European countries and Nordic countries. Also, despite the fact that unions are not that powerful in the US, there exists a form of minimum wage in the US. As such, a union pushing the wage above its perfectly competitive counterpart might be a valid assumption for all countries to introduce unemployment.

Firms in our model act competitively on the goods market. Furthermore, we introduce a government with a rich set of fiscal policy instruments. Government spending on goods and unemployment benefits are financed by taxes on labour, capital and consumption. As to labour taxes, we distinguish between taxes paid by the employer and the employees<sup>3</sup>. Another novelty is the modelling of progressive income taxes paid by the households. We follow the approach used by Guo and Lansing (1998) and Koyuncu (2011). Lump sum transfers balance the budget.

We then use our model to investigate the main drivers of the differences in unemployment across OECD countries. A large range of variables play a role in the model. To find out which of these matter most, our procedure is as follows. First, we calibrate our model and show its empirical relevance for twelve countries belonging to three groups (five continental European countries, four Nordic countries and three Anglo-Saxon countries). More precisely, we simulate our calibrated model for each country imposing common technology on all countries, but country-specific fiscal policy parameters and country group-specific household and union preferences. We also control for country-specific child care costs. We find that the predictions of our model match the main facts in most countries. These facts concern hours worked per employed person and the unemployment rate. Having established its empirical reliability,

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<sup>3</sup>In a perfect labour market situation, whether labour taxes are levied on workers or firms does not matter for the cost of labour, nor for after-tax wages and employment. However, as Heijdra and Ligthart (2009) argue, it is not immediately clear whether the same result holds in imperfectly competitive labour markets. We therefore choose to distinguish explicitly between the two.

we then use the model to find out what policy or preference parameters account for the cross-country differences in the aggregate unemployment rate. Our objective is similar to the one of Dhont and Heylen (2008), Wallenius (2013) and Alonso-Ortiz (2014) in earlier work. We make progress by also explicitly testing the potential explanatory power of labour market imperfections, different union preferences in particular, and different tastes for leisure of the households. Performing a Shapley decomposition, we find an almost equal role for differences in fiscal policy variables and in union preferences. Each account for about half of the explained variation in unemployment rates across countries. By contrast, any differences in the households' taste for leisure play virtually no role. Our story will then be that the above market-clearing wage chosen by the unions is the source of unemployment, while the fiscal policy variables explain a significant part of the magnitude of unemployment. Going into greater detail on the fiscal side, we find that the key variable driving cross-country differences in unemployment of lower ability individuals is the unemployment benefit replacement rate. In the Nordic countries and (even more) the continental European countries, this has a significant impact on the reference wage of the union. We find no contribution, however, from differences in labour taxes to account for cross-country unemployment variation on an interregional level.

Our finding that both policies and institutions should be taken into account for a good explanation of differences in unemployment across OECD countries matches well with the results of many econometric studies, like those of Nickell *et al.* (2005), Bassanini and Duval (2009), and Nymoen and Sparrman (2015). The generosity of the unemployment benefit system and the characteristics of wage setting are often found among the main drivers of unemployment in these studies. Our focus on unemployment among low educated workers, however, is missing in most econometric studies (despite its importance for the aggregate employment situation that we highlighted in Figure 1). As we have emphasized before, introducing a labour market imperfection and explaining unemployment is also our main contribution to the dynamic general equilibrium analysis of labour market performance in the tradition of Prescott (2004), Rogerson (2007), and Rogerson and Wallenius (2009), among others.

Several earlier contributions have made an attempt to introduce unemployment in dynamic macro models. Daveri and Tabellini (2000), Corneo and Marquardt (2000), and Ono (2010)

among others developed OLG models with a unionized labour market, while Ravn and Sørensen (1999), Cahuc and Michel (1996) and Sommacal (2006) introduced minimum wages. Gali *et al.* (2011) extended the Smets and Wouters New Keynesian DSGE model to allow for involuntary unemployment. In their model, unemployment also results from market power in labour markets, reflected in positive wage markups. Other authors embed a search and matching setup in a life-cycle model, e.g. de la Croix *et al.* (2013). We also make progress compared to this literature. First, to the best of our knowledge, all the existing OLG models where unions are present are populated by only two generations, which means that they lack a life-cycle dimension in labour supply. The fact that we model the labour market outcome of different generations is clearly also different from the DSGE literature on unemployment. Second, most of the models incorporating unions in an OLG model leave the intensive margin of employment (i.e. hours worked) unexplored. However, hours of work per employed person are substantially lower in most European countries than in the Anglo-Saxon countries. Third, most of these models do not allow for individuals with different ability. The consequence being that these are not suited to explore the labour market situation of lower educated individuals separately. And last, given the rich specification of our model, both in terms of fiscal and institutional variables, we are able to explore the drivers of unemployment in much more detail.

The structure of this paper is as follows. In Section II, we describe the basic setup of our model. Section III discusses optimal behavior of unions and firms, and how this drives hours worked, unemployment and real output. Section IV presents our calibration procedure. In Section V we test and show the empirical validity of our model for 12 OECD countries as described above. Finally, in Section VI we investigate the relative importance of institutional and (household and union) preference related variables versus several fiscal policy variables to explain differences across countries in the unemployment rate. Section VII concludes.

## **II. The model: setup, preferences and constraints**

Time is discrete and runs from 0 to infinity. We assume a small open economy populated by five overlapping generations of households, firms, unions and a fiscal government. Individual members of the household enter the model at the age of 18 and live for five periods  $j$  of 12



years. Individuals have either high or low innate ability. Households have only higher or lower ability members, but not both. Both the goods market and the labour market for higher ability individuals are competitive, whereas the labour market for lower ability individuals is unionized. In every period  $t$ , wages for lower ability workers are set by a monopoly union at the firm level. The government in our model disposes of a rich set of fiscal policy instruments. Government spending on goods and unemployment benefits are financed by taxes on capital, labour and consumption. As to labour taxes, we distinguish between taxes paid by the employer (linear) and by the employees (non-linear). There is no uncertainty.

### *Households*

In the spirit of Merz (1995) and Andolfatto (1996), we assume a number of households each consisting of a continuum of members of the same age and the same ability. Each household has unitary mass. We normalize the number of households of a given age and ability type to one. Therefore, the economy consists of 10 households in total<sup>4</sup>. All members at working age participate on the labour market and pool their income, meaning that consumption across household members is the same. As such there is perfect insurance within the household against the risk of unemployment. A household that enters the model in period  $t$  (a household of generation  $t$ ) is denoted with a superscript  $t$ . Subscripts are reserved for the age  $j \in \{1, 2, 3, 4, 5\}$  and the ability type  $a \in \{H, L\}$ . Hence,  $n_{2H}^{t+1}$  denotes the fraction of time devoted to labour services by a member of a higher ability family who is in the second period of life and who started active life in period  $t + 1$ . Tables 1 and 2 present a brief overview of the model structure with respect to the households:

- Members of the higher ability household enter the model with a human capital stock  $h_{1H}^t$ . They have a time endowment of one in each period which they can devote to work, education when young, or leisure. During four active periods (age  $j = 1, 2, 3, 4$ ), all these individuals are employed on a perfectly competitive labour market. During the fifth period ( $j = 5$ ), they

<sup>4</sup>With our assumption of five periods, we are able to isolate the young (18-29) and the elderly (54-65) and look at whether the model correctly predicts the labour market outcome for these generations. Including more generations would not lead to additional insights with respect to the aggregate unemployment rate. Having fewer generations might lead to generations that are too big (especially the young and the older workers).



Table 1. Life-cycle of a member of a higher ability household of generation  $t$ 

Time	$t$	$t + 1$	$t + 2$	$t + 3$	$t + 4$
Hours worked	$n_{1H}^t$	$n_{2H}^t$	$n_{3H}^t$	$n_{4H}^t$	0
Education	$e_{1H}^t$	0	0	0	0
Participation rate	1	1	1	1	0
Unemployment rate	0	0	0	0	0
Employment rate	1	1	1	1	0
Leisure time	$1 - n_{1H}^t - e_{1H}^t$	$1 - n_{2H}^t$	$1 - n_{3H}^t$	$1 - n_{4H}^t$	1

Table 2. Life-cycle of a member of a lower ability household of generation  $t$ 

Time	$t$	$t + 1$	$t + 2$	$t + 3$	$t + 4$
Hours worked when employed	$n_{1L}^t$	$n_{2L}^t$	$n_{3L}^t$	$n_{4L}^t$	0
Education	0	0	0	0	0
Participation rate	1	1	1	1	0
Unemployment rate	$u_{1,t}$	$u_{2,t+1}$	$u_{3,t+2}$	$u_{4,t+3}$	0
Employment rate	$1 - u_{1,t}$	$1 - u_{2,t+1}$	$1 - u_{3,t+2}$	$1 - u_{4,t+3}$	0
Leisure time when employed	$1 - n_{1L}^t$	$1 - n_{2L}^t$	$1 - n_{3L}^t$	$1 - n_{4L}^t$	1

are retired. The household chooses an optimal consumption path, the optimal amount of non-human wealth, the time each individual devotes to education when young and the amount of hours each member supplies labour.

– Members of the lower ability household enter with a human capital stock  $h_{1L}^t < h_{1H}^t$ . Just like their higher ability counterparts, they have a time endowment of one. Lower ability individuals do not pursue tertiary education. A fraction  $1 - u_{j,t+j-1}$  of all lower ability individuals of generation  $t$  at age  $j$  will be employed in period  $t + j - 1$ , the others are (involuntarily) unemployed. Employed members devote time to either work or leisure, unemployed members only have leisure. The household chooses an optimal consumption path, the optimal amount of non-human wealth and the amount of time the employed members supply labour.

Lifetime utility of the higher ability household of generation  $t$  is given by

$$u_H^t = \sum_{j=1}^5 \beta^{j-1} \left( \ln c_{jH}^t + \gamma_j \frac{(1 - e_{jH}^t - n_{jH}^t)^{1-\theta}}{1-\theta} \right) \quad (1)$$

with  $0 < \beta < 1$ ,  $\gamma_j > 0$ ,  $\theta > 0$  ( $\theta \neq 1$ ), and where  $e_{2H}^t = e_{3H}^t = e_{4H}^t = e_{5H}^t = n_{5H}^t = 0$ . In this equation,  $\beta$  represents the discount factor,  $\gamma_j$  is an age-specific parameter determining the value

of leisure relative to consumption and  $\frac{1}{\theta}$  is the intertemporal elasticity of substitution in leisure<sup>5</sup>. The household's budget constraints are given by (2). Income is derived from labour, non-human wealth and lump sum transfers from the government. It is allocated to either consumption or savings.

$$(1 + \tau_c)c'_{jH} + \Omega'_{jH} = w_{H,t+j-1}\varepsilon_j h'_{jH} g(n'_{jH})(1 - \tau_{jH})(1 - I_{cc}) + (1 + r_{t+j-1})\Omega'_{j-1,H} + z_{t+j-1} \quad (2)$$

for  $j \in \{1, 2, 3, 4, 5\}$  and with  $\Omega'_{0H} = \Omega'_{5H} = n'_{5H} = 0$ . As in Rogerson and Wallenius (2009),  $g(n'_{jH}) = \max\{n'_{jH} - \bar{n}_H, 0\}$ , with  $n'_{jH}$  the chosen fraction of their time endowment that individuals allocate to labour services and  $n'_{jH} - \bar{n}_H$  the effective labour time that individuals supply. We assume that if an individual with human capital stock  $h'_{jH}$  devotes a fraction  $n'_{jH}$  of his/her time to the labour market, this will yield  $(n'_{jH} - \bar{n}_H)h'_{jH}$  units of effective labour market services if  $n'_{jH} \geq \bar{n}_H$ , and 0 otherwise. A fraction  $\bar{n}_H$  is not productive due to e.g. commuting and getting set up in a job. Individuals earn an after-tax wage of  $w_{H,t+j-1}\varepsilon_j h'_{jH} g(n'_{jH})(1 - \tau_{jH})$  during their four active periods, where  $w_{H,t+j-1}$  is the pre-tax real wage per unit of effective labour,  $\varepsilon_j$  is an age-specific productivity parameter, and  $\tau_{jH}$  is the average tax rate on labour. Due to our modelling of a progressive labour income tax system, tax rates depend on individuals' ability and age. We specify the tax system in greater detail below. Young households allocate a fraction  $cc$  of their after-tax labour income to child care. This implies that the indicator function  $I_c$  equals 1 only if  $j = 1$ . We denote the lump sum transfer from the government at time  $t$  by  $z_t$ . The consumption tax rate is  $\tau_c$ . The households' accumulated non-human wealth at the end of their  $j$ -th period of life is  $\Omega'_{jH}$ . Households enter the model without wealth and leave no bequests.

Also for individuals of lower ability, the decision unit is the household. The key difference is that in this household only a fraction  $1 - u_{j,t+j-1}$  of the individuals is employed. A fraction  $u_{j,t+j-1}$  is unemployed. Hence,  $u_{j,t+j-1}$  represents the aggregate unemployment rate among the lower ability individuals of generation  $t$  at age  $j$  and time  $t + j - 1$ . The household derives utility from consumption, while it only enjoys utility from the leisure of each employed member<sup>6</sup>.

<sup>5</sup>In the empirical part of our paper (i.e. Sections IV and V), we allow  $\gamma_j$  to differ between regions (continental European countries, Nordic countries, and Anglo-Saxon countries). The region-specific values will be calibrated.

<sup>6</sup>A similar utility function is also used in business cycle and overlapping generations models with search and

Thus, lifetime utility of the household of lower ability individuals of generation  $t$  is given by

$$u_L^t = \sum_{j=1}^5 \beta^{j-1} \left( \ln c_{jL}^t + \gamma_j (1 - u_{j,t+j-1}) \left[ \frac{(1 - n_{jL}^t)^{1-\theta}}{1-\theta} \right] \right) \quad (3)$$

where  $n_{5L}^t = 0$ . The household's budget constraints are given by (4). Again, we assume that all members of the household pool their income.

$$(1 + \tau_c) c_{jL}^t + \Omega_{jL}^t = w_{L,t+j-1} \varepsilon_j h_{jL}^t (1 - u_{j,t+j-1}) g(n_{jL}^t) (1 - \tau_{jL}) (1 - I_{ccc}) + \tilde{B}_j + (1 + r_{t+j-1}) \Omega_{j-1,L}^t + z_{t+j-1} \quad (4)$$

for  $j \in \{1, 2, 3, 4, 5\}$  and with  $\Omega_{0L}^t = \Omega_{5L}^t = n_{5L}^t = 0$ . For the fraction  $u_{j,t+j-1}$  of its members who are unemployed, the household receives an unemployment benefit, equal to a fraction  $\tilde{b}_j$  of the after-tax labour income that these individuals would receive if they were employed. Formally,  $\tilde{B}_j = \tilde{b}_j w_{L,t+j-1} \varepsilon_j h_{jL}^t g(n_{jL}^t) (1 - \tau_{jL}) u_{j,t+j-1}$ , where  $j \in \{1, 2, 3, 4\}$ . The household takes both the unemployment benefit and the unemployment rate as given, when choosing consumption, savings and the supply of working hours. Note that, due to the progressivity of labour income taxes, lower ability households will face a different tax rate than higher ability households ( $\tau_{jL} < \tau_{jH}$ ).

### *Human capital*

Individuals enter our model at the age of 18 with a predetermined level of human capital. This level is generation-invariant, but higher for individuals with high innate ability. The latter reflects for example higher intelligence and greater capacity to learn and accumulate knowledge at primary and secondary school. We normalize the human capital of a young individual with high ability to  $h_0$ . A young individual with low ability enters the model with only a fraction  $\varepsilon_L h_0$ , where  $\varepsilon_L < 1$ . The parameter  $\varepsilon_L$  will be calibrated.

During youth, individuals with high ability will invest a fraction of their time in tertiary education. They accumulate more human capital, making them more productive in later periods.

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matching frictions, e.g. Tomas (2008) and de la Croix *et al.* (2013). As in these contributions, we assume that the leisure of the unemployed members is neutral in terms of utility.

Formally,

$$h_{2H}^t = h_{1H}^t(1 + \phi(e_{1H}^t)^\sigma) \text{ with } 0 < \sigma \leq 1, \phi > 0 \quad (5)$$

We adopt in Equation (5) a human capital production function similar to Lucas (1990) and Bouzahzah *et al.* (2002). The production of new human capital by these individuals rises in the amount of time they allocate to education ( $e_{1H}^t$ ) and in their initial human capital ( $h_{1H}^t$ ). The parameter  $\sigma$  indicates the elasticity of time input,  $\phi$  is an efficiency parameter. Individuals with low innate ability do not study. Their human capital remains constant:  $h_{2L}^t = h_{1L}^t$ . Finally, we assume that the human capital of all individuals remains unchanged after the second period. A rationale for this assumption is that learning-by-doing in work may counteract depreciation. This means that  $h_{4a}^t = h_{3a}^t = h_{2a}^t$ , for  $a \in \{H, L\}$ .

### Firms

Both the goods market and the labour market for higher ability individuals are perfectly competitive, whereas the labour market for lower ability individuals is unionized. All firms are identical. They maximize profits, pay taxes on capital income and social security contributions when hiring labour. Total domestic output is given by the production function (6). Production exhibits constant returns to scale in aggregate physical capital ( $K_t$ ) and labour in efficiency units ( $A_t H_t$ ). Given our assumption of perfect competition on the goods market, profits are zero in equilibrium.

$$Y_t = K_t^\alpha (A_t H_t)^{1-\alpha} \quad (6)$$

Technology  $A_t$  is growing at an exogenous and constant rate  $x$ :  $A_{t+1} = (1+x)A_t$ . As to total effective labour  $H_t$ , we assume that higher and lower ability individuals are imperfectly substitutable in production. This framework was pioneered by Katz and Murphy (1992). So,

$$H_t = \left[ \eta_H H_{H,t}^{\frac{\iota-1}{\iota}} + \eta_L H_{L,t}^{\frac{\iota-1}{\iota}} \right]^{\frac{\iota}{\iota-1}}, \text{ with } \eta_H + \eta_L = 1 \quad (7)$$

with  $\eta_a$  being a share parameter and  $\iota$  the elasticity of substitution between higher and lower ability labour. Furthermore, workers of the same ability type but different age are assumed to

be perfect substitutes. Formally, this gives respectively for higher and lower ability labour

$$H_{H,t} = \sum_{j=1}^4 (n_{jH}^{t-j+1} - \bar{n}_H) \varepsilon_j h_{jH}^{t-j+1}, \quad H_{L,t} = \sum_{j=1}^4 (1 - u_{j,t}) (n_{jL}^{t-j+1} - \bar{n}_L) \varepsilon_j h_{jL}^{t-j+1} \quad (8)$$

## Unions

The economy is populated by decentralized trade unions, operating at the firm level. Every single union represents all the lower ability workers in a firm. As such, unions are large compared to the workers. The union will determine the lower ability workers' wage while taking aggregate variables and fiscal policy parameters as given. Just like in e.g. Pencavel (1984) and de la Croix *et al.* (1996), the objective function of the union follows the Stone-Geary specification,

$$V_t = \sum_{j=1}^4 \left[ \frac{1}{\chi_j} (w_{L,t}(1 - \tau_{jL}) - \bar{w}_{j,t})^{\chi_j} (1 - u_{j,t}) \right] \quad (9)$$

with  $\chi_j > 0$ . The union derives utility from both wages and employment, albeit to a different degree<sup>7</sup>. As to wages, what matters is the difference between the after-tax wage  $w_{L,t}(1 - \tau_{jL})$  and a reference wage,  $\bar{w}_{j,t}$ . The age-specific parameter  $\chi_j$  measures the concavity with respect to the excess wage gap. The higher  $\chi_j$ , the higher the preference of the union for wages versus employment for the age group  $j$ . Every union has the same reference wage. We define this as a weighted average or combination of the after-tax wage that would prevail if the lower ability labour market were competitive, the after-tax wage of higher ability workers and the unemployment benefit. The respective weights are  $\rho_1$ ,  $\rho_2$  and  $\rho_3$ . They sum up to 1. Formally, the reference wage is given by  $\bar{w}_{j,t} = \rho_1 w_{L,t}^c(1 - \tau_{jL}^c) + \rho_2 w_{H,t}(1 - \tau_{jH}) + \rho_3 \tilde{b}_j w_{L,t}(1 - \tau_{jL})$ <sup>8</sup>.

## Government

Unemployment benefits and government spending on goods are financed by taxes on capital, labour (both on employers and employees) and consumption. Lump sum transfers ensure a

<sup>7</sup>In our companion paper (Boone and Heylen, 2015), we elaborate more in detail on the Stone-Geary functional form.

<sup>8</sup>Like for the household taste for leisure parameters ( $\gamma_j$ ), we also assume for  $\chi_j$  and  $\rho_k$  ( $j \in \{1, 2, 3, 4\}$  and  $k \in \{1, 2, 3\}$ ) that their empirical values may differ across country groups (continental European countries, Nordic countries, and Anglo-Saxon countries).

balanced budget. Formally,

$$G_t + B_{L,t} + Z_t = T_{nH,t} + T_{nL,t} + T_{k,t} + T_{c,t} \quad (10)$$

and

$$G_t = gY_t, \quad Z_t = 10z_t \quad (11)$$

$$T_{k,t} = \tau_k \alpha Y_t \quad (12)$$

$$T_{c,t} = \tau_c \sum_{j=1}^5 (c_{jH}^{t+1-j} + c_{jL}^{t+1-j}) \quad (13)$$

$$B_{L,t} = \sum_{j=1}^4 \tilde{b}_j w_{L,t} \varepsilon_j h_{jL}^{t+1-j} g(n_{jL}^{t+1-j})(1 - \tau_{jL}) u_{j,t} \quad (14)$$

$$T_{nH,t} = \sum_{j=1}^4 w_{H,t} g(n_{jH}^{t+1-j}) \varepsilon_j h_{jH}^{t+1-j} (\tau_{jH} + \tau^p) \quad (15)$$

$$T_{nL,t} = \sum_{j=1}^4 w_{L,t} (1 - u_{j,t}) g(n_{jL}^{t+1-j}) \varepsilon_j h_{jL}^{t+1-j} (\tau_{jL} + \tau^p) \quad (16)$$

The government spends a fraction  $g$  of output on goods. In Equations (15) and (16),  $\tau_{ja}$  is the average tax rate that applies to the labour income of an individual of age  $j$  and ability  $a$  and  $\tau^p$  is the tax rate paid by the employer. What remains is the specification of progressive income taxes. The tax rates appearing in the budget constraints of the households are average tax rates and given by  $\tau_{ja} = \Gamma \left( \frac{y_{ja,t}^{lab}}{\bar{y}_t^{lab}} \right)^\xi$ , where  $\xi \geq 0$  and  $0 < \Gamma \leq 1$ . Here,  $y_{ja,t}^{lab}$  is total pre-tax labour income of the household at time  $t$  and  $\bar{y}_t^{lab}$  is the average labour income in the economy. Just like in Guo and Lansing (1998) and Koyuncu (2011), the parameters  $\xi$  and  $\Gamma$  govern the slope and level of the tax schedule. The average tax rate  $\tau_{ja}$  increases with the total taxable labour income of the household when  $\xi > 0$ . Households are aware of the progressive structure of the tax system when making decisions, but take this as given. The marginal tax rate  $\tau_{ja}^m$  is then simply the rate applied to the last euro earned:  $\tau_{ja}^m = (1 + \xi) \Gamma \left( \frac{y_{ja,t}^{lab}}{\bar{y}_t^{lab}} \right)^\xi$ . Rewriting this yields  $\frac{\tau_{ja}^m}{\tau_{ja}} = 1 + \xi$ . The marginal tax rate is higher than the average tax rate when  $\xi > 0$ , i.e. the tax schedule is said to be progressive. When  $\xi = 0$ , the average and marginal tax rates coincide.

### III. Optimisation and Equilibrium

All households choose optimal consumption in each period of life and hours worked when employed. Households of higher ability will also choose the fraction of time allocated to education

when young. The first order conditions are standard. We report them in our supplementary online appendix A. Our focus in this section is on the maximization problem of the firms and unions. Moreover, we also present a detailed description of how we solve for the subgame perfect equilibrium of the game played between a triplet of a union, a firm and a household. For a description of the general equilibrium of our model, we refer to our online appendix B.

### *Firms*

The representative firm in our model operates in a small open economy with perfect mobility of physical capital. It chooses the optimal capital stock and the amount of effective labour. In terms of production, the firm prefers a combination of few people working more hours over a combination of many people working few hours, as each individual causes a time cost for commuting and getting setup in a job. More precisely, firms maximize profits with respect to the vector  $[K_t, H_{1H,t}, H_{2H,t}, H_{3H,t}, H_{4H,t}, (1 - u_{1,t}), (1 - u_{2,t}), (1 - u_{3,t}), (1 - u_{4,t})]$ , leading to the following first order conditions,

$$\alpha \left[ \frac{A_t H_t}{K_t} \right]^{(1-\alpha)} (1 - \tau_k) = r_t \quad (17)$$

$$(1 - \alpha) A_t^{1-\alpha} \left[ \frac{K_t}{H_t} \right]^\alpha \eta_a \left[ \frac{H_t}{H_{a,t}} \right]^{\frac{1}{i}} = w_{a,t} (1 + \tau^p), \quad a \in \{H, L\} \quad (18)$$

where  $H_{H,t}$  and  $H_{L,t}$  are defined in Equation (8) and  $\eta_H = 1 - \eta_L$ . Due to the perfect mobility of capital, the firm in Equation (17) will hire capital until its after-tax marginal product equals the exogenous world interest rate,  $r_t$ . There is no depreciation of capital. Whenever the net return to investment exceeds the world interest rate, capital will flow into the country until optimality is restored. According to Equation (18), firms hire higher and lower ability labour up to the point where their marginal product equals their real wage cost. On the labour market for higher ability workers, wages are determined competitively. Wage flexibility on this market implies that they will all work. The wage will be such that the total supply of higher ability labour,  $H_{H,t}$ , in Equation (8) equals the firms' demand in (18). For lower ability workers, however, the wage is controlled by the union. Since hours of work are chosen by the households, in order to



satisfy Equation (18) the firm can only choose the fraction of persons it wants to employ, or the unemployment rate.

Our assumptions of constant population and of individuals entering the model with a pre-determined and generation-invariant level of human capital imply that in steady state effective labour will be constant. Physical capital, output and real wages by contrast will all grow at the exogenous technology growth rate  $x$ .

### Union

The union chooses the wage  $w_{L,t}$  to maximize Equation (9) subject to the firm's and the lower ability households' optimal choice of (un)employment and hours of work, i.e.

$$\text{s.t.} \begin{cases} F(n_{jL}^{t-j+1}, 1 - u_{j,t}, w_{L,t}) = (1 - \alpha)A_t^{1-\alpha} \left[ \frac{K_t}{H_t} \right]^\alpha \eta_L \left[ \frac{H_t}{H_{L,t}} \right]^{\frac{1}{i}} - w_{L,t}(1 + \tau^p) = 0 \\ G(n_{jL}^{t-j+1}, 1 - u_{j,t}, w_{L,t}) = \frac{\gamma_j}{(1 - n_{jL}^{t-j+1})^\theta} - \frac{w_{L,t} \varepsilon_j h_{jL}^{t-j+1} (1 - \tau_{jL}^m)(1 - I_{cc})}{(1 + \tau_c) c_{jL}^{t-j+1}} = 0 \end{cases}$$

with  $j \in \{1, 2, 3, 4\}$ . To derive the first order condition, one has to know how the optimal unemployment rate resulting from the second stage of the game changes when the chosen wage changes. From the second stage, we derive a system of two implicit equations in the supply of hours worked, the unemployment rate, and the wage rate.

Using matrix notation, evaluating at the equilibrium values of the supply of hours worked, the unemployment rate, and the wage rate, and taking the total differential yields:

$$\begin{bmatrix} \frac{\partial F}{\partial n_{jL}^{t-j+1}} & \frac{\partial F}{\partial (1 - u_{j,t})} \\ \frac{\partial G}{\partial n_{jL}^{t-j+1}} & \frac{\partial G}{\partial (1 - u_{j,t})} \end{bmatrix} \begin{bmatrix} dn_{jL}^{t-j+1} \\ d(1 - u_{j,t}) \end{bmatrix} = \begin{bmatrix} -\frac{\partial F}{\partial w_{L,t}} dw_{L,t} \\ -\frac{\partial G}{\partial w_{L,t}} dw_{L,t} \end{bmatrix} \quad (19)$$

Under normal parameter values the (2x2)-matrix is non-singular. We can then take the inverse to calculate  $\frac{d(1 - u_{j,t})}{dw_{L,t}}$ , the change in the equilibrium unemployment rate resulting from the second stage of the game, following an increase in the chosen wage rate by the union. Imposing the assumption that the union treats every generation equally when it comes to generating union

utility, the first order condition of the union is given by<sup>9</sup>:

$$w_{L,t}(1 - \tau_{jL}) - \bar{w}_{j,t} = -\frac{\chi_j(1 - u_{j,t})}{\frac{\partial(1 - u_{j,t})}{\partial w_{L,t}}}(1 - \tau_{jL}^m), \quad j \in \{1, 2, 3, 4\} \quad (20)$$

As the right-hand side of this equation is positive, the left-hand side has to be positive as well. This implies that the after-tax wage determined by the union will exceed the reference wage. The higher  $\chi_j$  (i.e. the relative weight on wages as opposed to employment for age group  $j$ ), the higher the ex-ante union wage premium. Ex-post, a rise in  $\chi_j$  will also be reflected in higher unemployment  $u_j$ , though. The reason is that if the union has a higher preference for wages for a particular age group, the firm will in the end replace the workers of this age group by low ability workers of other age. Unemployment among these other age groups might fall. Due to more expensive low ability labour, however, aggregate unemployment among low ability workers will rise.

### *Solving for the Subgame Perfect Equilibrium*

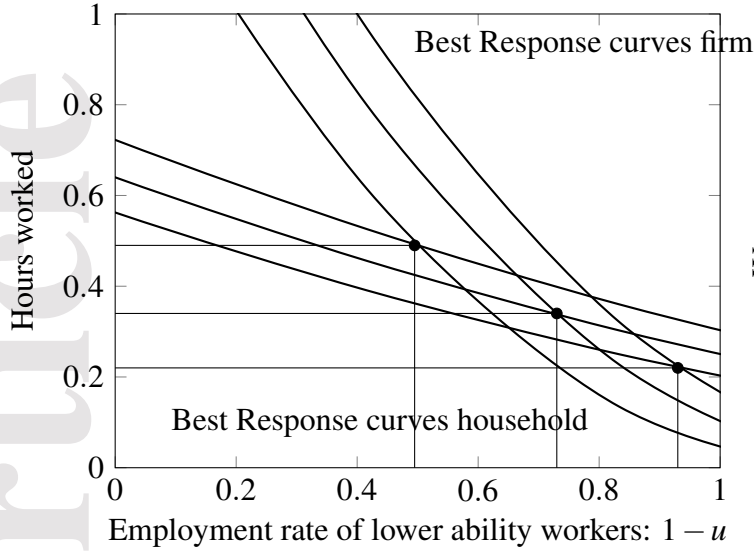
Within every period  $t$ , a dynamic two-stage game is played between a triplet of a firm, a union and a lower ability household. In the first stage, the unions choose the wage for the lower ability workers, whereas in the second stage firms choose the fraction of people they want to employ, and lower ability households choose their labour supply in hours. As such, the second stage is a static game, played between the firm and the lower ability household. We use backward induction to solve for the subgame perfect equilibrium of our game. In the second stage, the firm and the households play simultaneously, taking the union's wage, the fiscal policy variables, and the action of the other player as given. In the previous sections, we already solved for the best responses of the household and the firm. In Graph 1, we show the second stage of the game. The flatter curves are the 'best response'-functions of the households given the real wage rate, the unemployment rate chosen by the firm, tax rates and the unemployment benefit. If the unemployment rate increases, the income and consumption of the household will decrease, implying that the marginal benefit of working increases. Household members

<sup>9</sup>For details on the derivation of this equation, we refer the reader to our online appendix D.

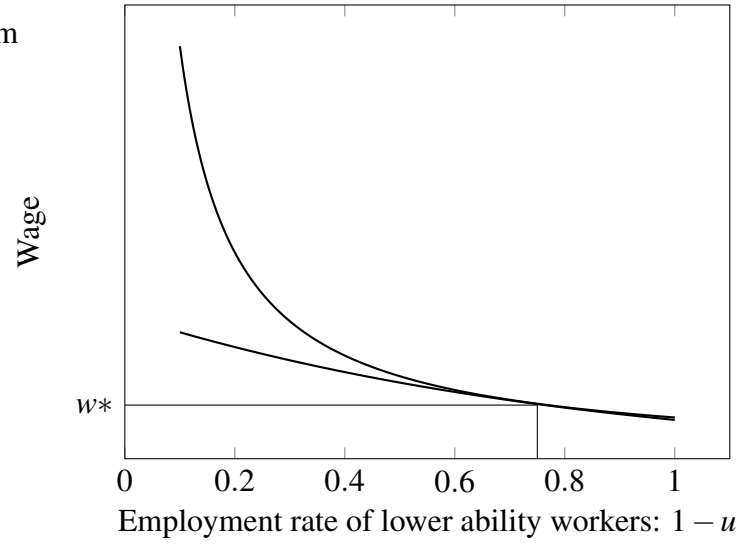
will then supply more hours. This argument explains the negative slope of the households' best-response curves. If the wage chosen by the union increases, the best-response curves shift upwards, leading to a higher supply of hours for a given unemployment rate. Intuitively, the substitution effect of a higher wage dominates the income effect. The best-response curves of the firm are calculated using the first-order conditions of the firm. If the households decide to supply more hours for a given wage rate, the firm will employ fewer people. If the wage chosen by the union increases and households maintain their supply of hours, the firm will also employ fewer people, implying that the best-response curves will shift to the left. The intersection of the 'best response'-functions for different wage rates represent the Nash equilibria of the second stage of our game. In Graph 2, an indifference curve of the union has been drawn. The other curve is the collection of Nash equilibria for different wage rates resulting from the second stage of the game. This curve indicates the employment rates which are Nash Equilibria in the second stage given different levels of the real wage rate.

The optimal combination of the wage and the employment rate is found where the indifference curve of the union is tangent to the Nash-function of the second stage. In Graph 2, one optimal point is drawn. From this value for the wage, we can calculate the exact Nash equilibrium in the second stage. The firm chooses the different employment rates such that Equation (18) holds for every age group. The exact composition of employment follows from the second stage of the game. First, notice that Graph 2 only represents one age group. To solve the full game, one needs a similar graph for all age groups (four in total). Then, for a given wage rate chosen by the union, the best-response curves of the firm and the household will be different over the age groups. The workers of an old household react differently to an increase in the wage compared to the members of the youngest household, for example. The same goes for the firm. Given the same wage increase, as there are differences in productivity and the amount of hours worked, the decrease in the employment rate for the oldest workers which is required to restore optimality (Equation 18) will differ from the required decrease for the youngest workers. Thus, the shift in the best-response curves of the household and the firm will be different over all the ages and therefore, for the same wage, one will obtain different employment rates. Finally, as every game is symmetric, the wage will be the same at every firm in the economy.

Graph 1: Second stage of the game



Graph 2: First stage of the game



#### IV. Calibration and empirical relevance of the model

In a first step, we calibrate our model and compare its predictions regarding the main labour market variables to the data for three groups of countries: Anglo-Saxon countries (the US, the UK and Canada), continental European countries (Belgium, France, Germany, the Netherlands, and Austria) and Nordic countries (Denmark, Finland, Norway and Sweden). To make our predictions, we impose common technology and productivity parameters on all countries. Most household and all union preference parameters are assumed to be common for the countries within the same group, but they may differ across groups. The parameters involved are the relative utility of leisure versus consumption for the households ( $\gamma_j$ ), the relative weight that the unions assign to wages as opposed to employment ( $\chi_j$ ), and the relative weight of each of the three determinants of the unions' reference wage ( $\rho_k$ ). To highlight their country group or region-specific character we add a superscript  $R$  to these parameters from now on, which gives  $\gamma_j^R, \chi_j^R$  and  $\rho_1^R, \rho_2^R$  and  $\rho_3^R$  respectively, with  $j \in \{1, 2, 3, 4\}$  and  $R \in \{Eur, Ang, Nor\}$ . Last but not least, all fiscal policy parameters, the time cost of commuting and the cost of child care are country-specific.

All common and all country group-specific parameters are reported in Table 3 below. So are the country-group averages of the unemployment rate by age, the country-group averages of hours worked per employed person by age, and the overall average education rate and per

capita growth rate. These performance indicators play an important role in our calibration, as we will describe immediately. First, however, we say more about the construction of our main data. For the country-specific data on labour market performance, fiscal policy parameters, the time cost of commuting and the cost of child care, we refer to our online appendix C.

## Data

In our model we have assumed that all individuals (except the retired) of both higher and lower ability participate in the labour market. Those of higher ability will all work. Among those of lower ability, only a fraction  $1 - u_{j,t}$  will work. The difference between both employment rates corresponds to the *rate of unemployment*  $u_{j,t}$ . The data for unemployment that we report in Table 3 reflect this setup. They are the difference in percentage points between the actual employment rate (in persons) among those within a particular age group who enjoyed tertiary education and those who did not. Although consistent with the setup of our model, this proxy for unemployment among the lower educated differs from official unemployment series. Our unemployment rate also captures differences in the labour market participation rate between high and low educated individuals in the data. Lower participation among low educated individuals implies higher unemployment in our data. When we account for cross-country differences in unemployment in Section V, our results will then also capture any impact of household preferences, union preferences, and fiscal policy on participation. This should not affect our main conclusions, though<sup>10</sup>. The (negative) correlation in actual data between the difference in employment rates and the difference in unemployment rates between higher and lower educated individuals is strong (see also Figure 1.c). Depending on the age group considered, it varies between -0.60 and -0.85. Our data for *hours worked per employed*  $n$  indicate the fraction of time that employed individuals devote to work relative to their total time endowment on an annual basis. We follow Wallenius (2013) in our computation<sup>11</sup>. The *education rate*  $e$  is the fraction of time that higher ability individuals devote to tertiary education. The data reflect the number

<sup>10</sup>Balleer *et al.* (2009) have investigated the determinants of labour force participation in the euro area. They find that labour taxes, union density and unemployment benefits have had an impact, but this impact is not robust in sign nor statistical significance across age and gender groups, and countries. Moreover, since the deeper objective of this paper is to contribute to an explanation of labour market performance, and employment in particular (see the introduction to this paper), our approach to compute unemployment rates is even to be considered an advantage.

<sup>11</sup>We assume that the total time endowment of each individual is 14 hours a day, 7 days a week and 52 weeks per year. This time can be allocated to work, leisure or (for young higher ability individuals) education.

of students in tertiary education in full-time equivalents divided by (the assumed higher ability) half of the population of age 18-29.

### *Calibrated parameters*

How well does our model match reality in individual countries? To find out, we first parameterize the model. We discuss our procedure in this section. Table 3 contains an overview of all parameters. Many have been set in line with, or taken from, the existing literature. Others have been calibrated to match key data.

We set the rate of time preference at 2% per year and the (exogenous and constant) world real interest rate at 4.5% per year. Considering that periods in our model last 12 years, this choice implies a discount factor  $\beta = 0.788$  and interest rate  $r = 0.696$ . In the production function for goods, we assume a capital share coefficient  $\alpha$  equal to  $1/3$ . Following Caselli and Coleman (2006), who state that the empirical labour literature consistently estimates values between 1 and 2, we set the elasticity of substitution  $\iota$  between the two ability types in effective labour equal to 1.5. We set  $\theta = 4$ . Rogerson (2007) considers a value for the inverse of the intertemporal elasticity of substitution in leisure  $\theta$  between 1 and 3 as reasonable. We do not have an endogenous participation decision, however. Therefore, we adopt a value for  $\theta$  that is somewhat higher. For the age-specific productivity parameters  $\varepsilon_j$ , we follow the hump-shaped pattern imposed by Miles (1999). We impose the same  $\varepsilon_j$  for both ability types.

Three parameters relate to the production of human capital and to the level of human capital with which individuals enter the model. For the elasticity with respect to education time ( $\sigma$ ) we choose a conservative value of 0.3. This value is within the range considered by Bouzahzah *et al.* (2002), but much lower than the value imposed by Lucas (1990). To determine the relative initial human capital of lower ability individuals (relative to the initial human capital of high ability individuals,  $\varepsilon_L$ ) we follow Buyse *et al.* (2017) who rely on PISA science scores. We use the average of the test scores of students at the 17th and the 50th percentile as representative for lower ability individuals in our model, and the test score of students at the 83th percentile as representative for high ability individuals. The data are remarkably robust across countries. The science test scores of students at the 17th percentile and students at the 50th percentile are

Table 3. Basic Parameterization of the model

Parameters imposed on all countries - Values			
Discount factor in utility	$\beta$		0.788
World real interest rate	$r$		0.696
Capital share parameter in goods production	$\alpha$		0.33
Elasticity of substitution between different ability types of labour	$\iota$		1.5
Inverse of the intertemporal elasticity of substitution in leisure	$\theta$		4
Age-specific productivity parameters	$\varepsilon_1, \varepsilon_2, \varepsilon_3, \varepsilon_4$		2.325, 2.770, 2.776, 2.341
Relative initial human capital of lower ability individuals (to $h_0$ )	$\varepsilon_L$		0.755
Elasticity of human capital with respect to education time	$\sigma$		0.3
Efficiency parameter in human capital production	$\phi$		2.10
Share parameter of higher ability individuals in effective labour	$\eta_H$		0.599
Exogenous technology growth	$x$		0.206
Calibrated region-specific parameters			
	cont. European	Nordic	Anglo-Saxon
$\gamma_1^R$	0.124	0.162	0.054
$\gamma_2^R$	0.424	0.347	0.326
$\gamma_3^R$	0.384	0.314	0.295
$\gamma_4^R$	0.319	0.275	0.258
$\chi_1^R$	2.489	1.837	1.591
$\chi_2^R$	4.016	2.511	2.721
$\chi_3^R$	4.074	2.572	2.734
$\chi_4^R$	4.477	3.005	2.815
$\rho_1^R$	0.8	0.9	0.9
$\rho_2^R$	0.05	0	0.1
$\rho_3^R$	0.15	0.1	0
Target values for the calibrated parameters $\phi$ , $x$ , and $\eta_H$ (2001-07)			
Education rate ( $e$ ) (average over 12 countries)			11.7%
Per capita annual growth (average over 12 countries)			1.57%
Relative gross wage of young low versus high educated workers US			0.53
Region-specific targets: unemployment and hours worked by age (2001-07)			
	cont. European	Nordic	Anglo-Saxon
$u_1$	14.0%	8.7%	16.9%
$u_2$	14.9%	11.8%	14.8%
$u_3$	15.5%	12.7%	14.7%
$u_4$	20.3%	18.7%	17.2%
$n_1$	0.295	0.293	0.331
$n_2$	0.313	0.343	0.371
$n_3$	0.313	0.343	0.371
$n_4$	0.306	0.331	0.355

Note: For the country-specific data on unemployment by age, hours worked by age, and education, as well as all country-specific fiscal policy parameters (tax rates and unemployment benefits) and country-specific data for the cost of child care and the time cost of commuting, we refer to our online appendix C. The cross-country average values for these parameters are:  $\xi = 0.337$ ,  $\Gamma = 26.3$ ,  $\tau_c = 14.3$ ,  $\tau^p = 18.8$ ,  $\tilde{b}_j = 53.4$ ,

$$\tau_k = 22.1, g = 25.7, cc = 0.139, \bar{n} = 0.059$$

always very close to 67% and 85% of the test score of students at the 83th percentile<sup>12</sup>. The

<sup>12</sup>The data that we report are averages of the PISA results for the years 2000, 2003 and 2006. The available data



differences across countries being so small, we take these relative scores as objective indicators of the relative cognitive capacity of lower and high ability individuals, and will correspondingly set  $\varepsilon_L$  equal to 0.755 (= the average of 0.67 and 0.85). Last but not least, the efficiency parameter  $\phi$  in the human capital production function of the individuals with high ability has been determined by a calibration procedure that we discuss now.

We determined 36 parameters by calibration. Next to the efficiency parameter in human capital production ( $\phi$ ), these are the exogenous technology growth rate ( $x$ ), the share parameter in aggregate effective labour ( $\eta_H$ ), the four household taste for leisure parameters ( $\gamma_1^R, \gamma_2^R, \gamma_3^R, \gamma_4^R$ ), the four union 'preference for wage' parameters ( $\chi_1^R, \chi_2^R, \chi_3^R, \chi_4^R$ ), and the three weights in the unions' reference wage ( $\rho_1^R, \rho_2^R, \rho_3^R$ ). The former three parameters ( $\phi, \eta_H, x$ ) are assumed to be the same for all countries. The 11 household and union preference parameters may differ by country group. The efficiency parameter in human capital production ( $\phi$ ) is determined to correctly predict average participation in tertiary education ( $e$ ) over individuals of age 18-29 in all twelve countries in our sample. The parameter turns out to be 2.1. The exogenous growth rate of technology ( $x$ ) is calibrated to match actual per capita growth. The underlying target for the annual growth rate is 1.57%, being the average annual growth rate of real potential GDP per capita in our sample of twelve countries in 2001-2007. Following Buyse *et al.* (2017), we calibrate the share parameter in aggregate effective labour ( $\eta_H$ ) to match the relative wage of young workers without a tertiary degree versus young workers with tertiary degree in the US. This relative wage is 0.53<sup>13</sup>. As shown by Equation (18), the share parameter  $\eta_H$  is an important determinant of the relative productivity of labour and relative wages. Actual wages are informative if a close link can be assumed between wages and productivity. This condition is much more likely fulfilled in the US than in Europe, which explains the introduction here of US relative wages. The value for  $\eta_H$  that emerges is 0.599.

Finally, we calibrated the four taste for leisure parameters of the households ( $\gamma_j^R$ ), the four union preference for wage parameters ( $\chi_j^R$ ), and the weights in the reference wage of the union for the hypothetical competitive wage for lower ability workers ( $\rho_1^R$ ), the wage of higher ability

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concern students aged 15.

<sup>13</sup>OECD data (Education at a Glance, 2009, table A7.1a) show a relative wage of 0.43 for workers of age 25-34 without upper secondary education versus workers of this age with a tertiary degree. The relative wage of workers of age 25-34 with upper secondary degree is 0.63. On average this is 0.53.

workers ( $\rho_2^R$ ), and the unemployment benefit ( $\rho_3^R = 1 - \rho_1^R - \rho_2^R$ ) for each of the three country groups. That is a total of 33 parameters. To do this, we used a procedure in line with Heylen and Van de Kerckhove (2013). Basically, this procedure comes down to (i) exactly matching the 24 country-group averages of the unemployment rates and hours worked by age reported at the bottom of Table 3, and (ii) to minimize the deviation of our model's predictions for the aggregate unemployment rate (over all age and both ability groups) from the data in the twelve individual countries in our sample. More precisely, in a first step we imposed 9 values for  $\rho_1^R, \rho_2^R$  and  $\rho_3^R$  ( $R \in \{Eur, Nor, Ang\}$ ). With these imposed values we calibrated the 12 parameters  $\chi_j^R$  and the 12 parameters  $\gamma_j^R$  with  $j = \{1, 2, 3, 4\}$  and  $R \in \{Eur, Nor, Ang\}$  to exactly match the country-group averages of actual unemployment rates  $u$  in four generations and the country-group averages of actual hours worked  $n$  per generation (over both ability types). The obtained set of household taste for leisure and union preference parameters for each of the three country groups - together with all other calibrated parameters - would then allow us to compute the predictions of our model for all unemployment rates and all hours worked in all generations in each of the twelve countries in our sample separately. We repeated this procedures many times, each time starting from different values for  $\rho_1^R, \rho_2^R$  and  $\rho_3^R$ . Our guideline to pin down our final values for these parameters and the corresponding values for  $\gamma_j^R$  and  $\chi_j^R$  was to minimize the deviation of our model's predictions from the actual data for the aggregate unemployment rate (over all age and ability groups)<sup>14</sup>.

The results in Table 3 reveal by far the highest values for  $\chi_j^{EUR}$  in continental Europe, which implies that in these countries union indifference curves are flatter, wages are more rigid and the union wage mark-up is higher. Given the dominance of sectoral wage bargaining in these countries, this result matches well with the famous Calmfors and Driffill (1988) hypothesis. Furthermore, we observe that in each country group  $\chi_j^R$  rises in the age of the workers involved. Wages are therefore the most (least) rigid and the highest (lowest) for the oldest (youngest) workers. Seniority pay systems and the insider-outsider theory may provide an explanation for this result. As to the specific weights in the unions' reference wage, we notice in each country

<sup>14</sup>From the predictions of our model and the data for 12 countries we computed each time for the aggregate unemployment rate the root mean squared error normalized to the mean. We minimized the average normalized RMSE.

group a major role for the competitive wage of lower ability individuals ( $\rho_1^R \geq 0.8$ ). In the Anglo-Saxon countries the only other variable that matters in the unions' reference wage is the wage of the high skilled. In the Nordic countries, it is the unemployment benefit. In continental Europe, both these other variables have an impact on union wage setting, with unemployment benefits being more important. For the household taste for leisure parameters  $\gamma_j^R$ , we observe the lowest values in the Anglo-Saxon countries, which would confirm Blanchard (2004). Except among the youngest households, however, relative cross-country differences in  $\gamma_j^R$  are fairly small.

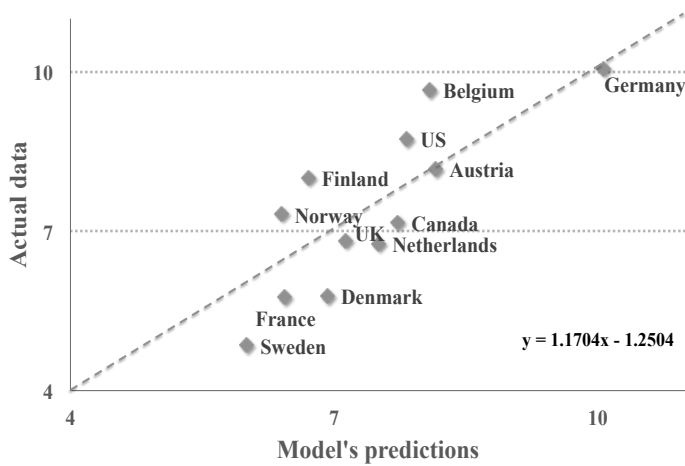
## V. Evaluation and empirical relevance of the model

In Figures 2-4, we evaluate the empirical relevance of the model regarding the cross-country variation in unemployment and hours worked. The interrupted line in each figure is the 45°-line. In each figure, we also report the slope of the regression line (not shown). Plugging each country's fiscal policy parameters and data for the cost of child care and the time cost of commuting into our calibrated model, it matches the facts for the aggregate unemployment rate very well. Correlation between the predictions of the model and the facts in Figure 2.a is over 80%, with a slope of the regression line fairly close to 1. Our model also captures the cross-country differences in the unemployment rates of different age groups quite well. Figure 3 shows this for the youngest and the oldest age groups. Last but not least, in Figures 2.b and 4 our model explains an important fraction of cross-country differences in hours worked per employed. The reported slope of the regression line in these figures remains a little below 1, though, suggesting that our model somewhat exaggerates the effect of policy differences on hours worked.

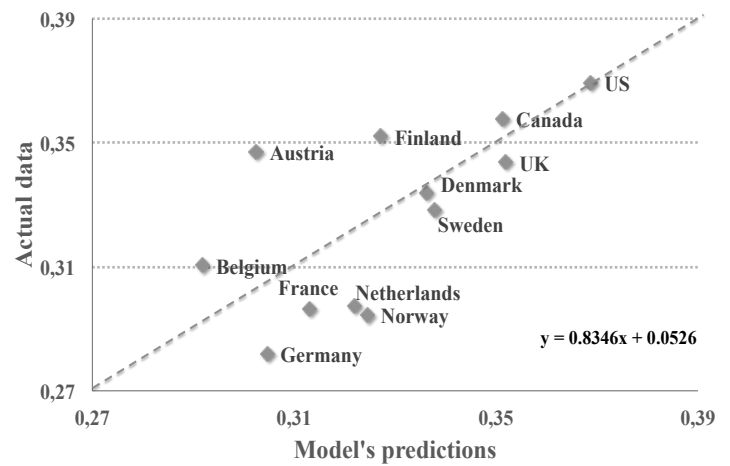
## VI. Accounting for cross-country variation in unemployment

Figure 2.a showed large differences across OECD countries in the unemployment rate. From Figure 1 we know that these differences explain an important fraction of cross-country differences in aggregate employment and labour market performance. The final step in this research

Fig. 2. Aggregate labour market performance in individual countries (2001-07)

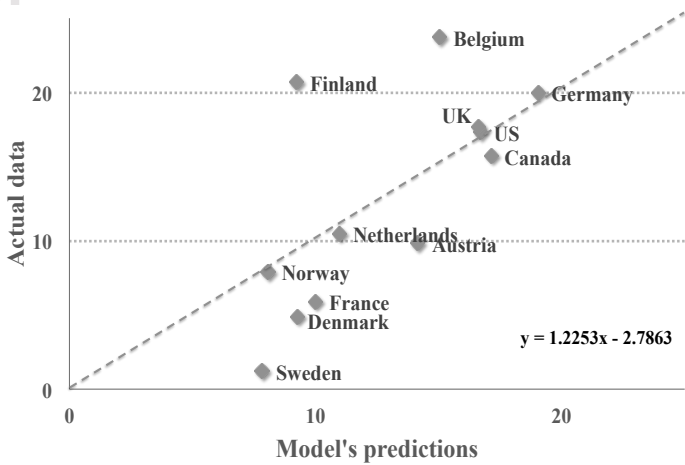


(a) Unemployment rate (in %) - Correlation: 0.809

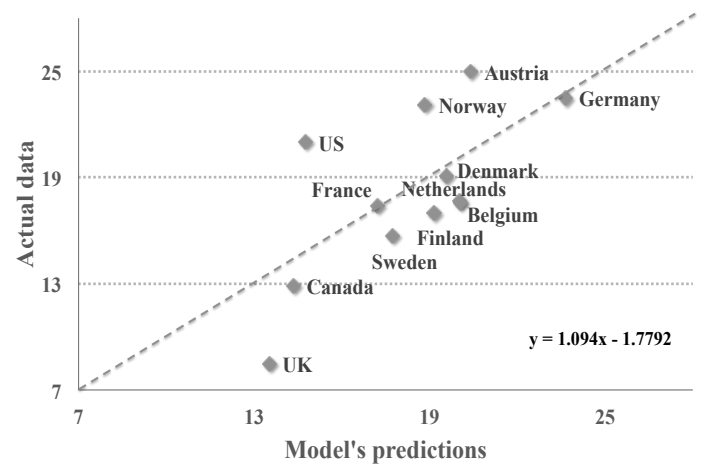


(b) Hours worked per employed - Correlation: 0.656

Fig. 3. Unemployment rate (%) among lower ability individuals

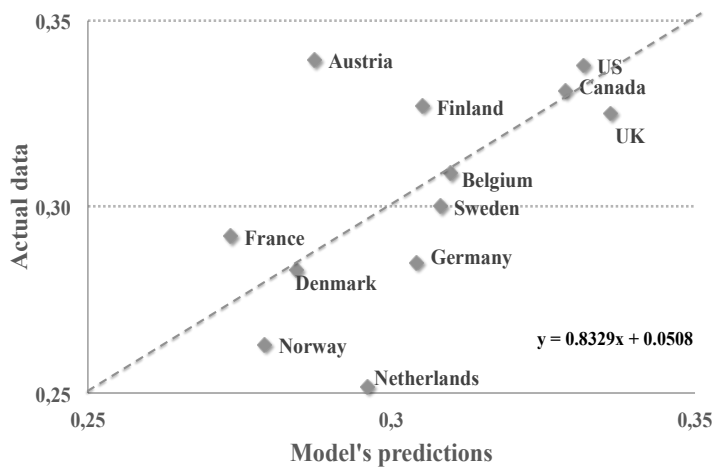


(a) Young (age 18-29) - Correlation: 0.685

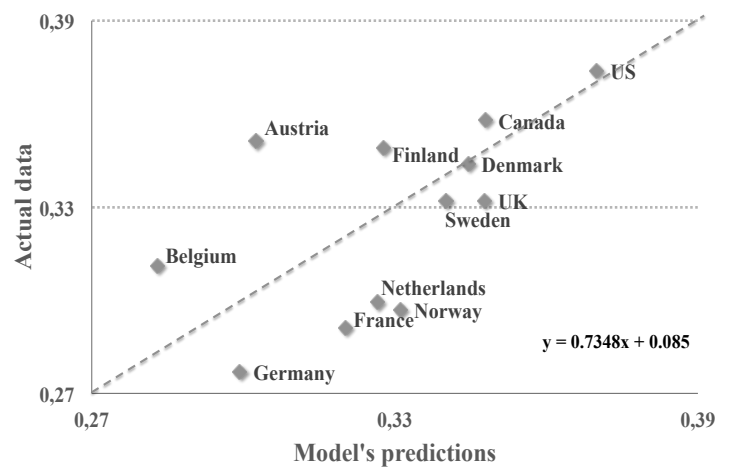


(b) Older (age 54-65) - Correlation: 0.689

Fig. 4. Hours worked by age over both ability types



(a) Young (age 18-29) - Correlation: 0.59



(b) Older (age 54-65) - Correlation: 0.585

is to account for these unemployment differences. What exactly causes higher unemployment in some countries compared to other countries?

### *Description of the experiment*

We find a correlation of 0.809 between the predictions of our model for the aggregate unemployment rate and the unemployment data. From this, we derive a  $R^2$  of 0.654. Following Israeli (2006), we perform a Shapley decomposition of the  $R^2$ -coefficient in order to evaluate the relative importance of the different fiscal policy variables, union wage setting and household preferences in generating cross-country unemployment differences. More specifically, according to a Shapley decomposition, the contribution of each of our variables equals its marginal effect measured by the change in the  $R^2$ -coefficient after eliminating the cross-country differences in this variable. This change in  $R^2$  is computed for every subset  $S$  of other explanatory variables. For example, if we had four explanatory variables,  $x_1, x_2, x_3$ , and  $x_4$ , the marginal effect of  $x_1$  on  $R^2$  would be  $M_1 = R^2[x_1, S \subseteq \{x_2, x_3, x_4\}] - R^2[S \subseteq \{x_2, x_3, x_4\}]$  for every subset  $S$ . Next, we take a weighted average over all these marginal effects where the weight is respectively  $\frac{s!(n-s-1)!}{n!}$ , with  $s$  the number of elements in the subset and  $n$  the total number of explanatory variables. Hence, for each of our variables in the Shapley decomposition, we successively replace their country-specific values by the average value over all countries in our sample, implying that we shut down the influence of these specific variables in generating cross-country differences in the unemployment rate. These variables are (i) the labour taxes imposed on employers and employees; (ii) the replacement rate in the unemployment benefit formula; (iii) the tax rate on capital; (iv) the tax rate on consumption; (v) government spending on goods; (vi) the time cost of commuting and the cost of child care; (vii) the union preference parameters, and (viii) the taste for leisure of the households.

Our model is able to generate cross-country variation in aggregate unemployment due to these country-specific and region-specific variables. The Shapley decomposition makes it possible to formally explore the contribution of the variation in each of those variables to the predicted variation in the aggregate unemployment rate. While the decomposition can be applied to any model independent of the underlying theory, we believe that there are a few features of our model and our results that make the Shapley decomposition highly relevant. First, the richer

Table 4. Shapley Decomposition of the aggregate unemployment rate

Variables		Contribution to $R^2$	
Preferences/Institutions		Absolute	Relative
Wage preference of union	$\chi^R$	0.227	34.7%
Weights in union reference wage	$\rho_1^R, \rho_2^R, \rho_3^R$	0.135	20.6%
Household taste for leisure	$\gamma_j^R$	-0.019	-2.9%
<b>Total preferences/institutions</b>		0.343	52.4%
Fiscal policy		Absolute	Relative
Tax on employers, employees, consumption	$\tau^p, \xi, \Gamma, \tau_c$	-0.057	-8.7%
Net unemployment benefit replacement rate	$\tilde{b}_j$	0.204	31.2%
Tax on capital income	$\tau_k$	0.058	8.9%
Fraction of output spent on goods	$g$	0.101	15.4%
<b>Total fiscal policy</b>		0.306	46.8%
Commuting cost, child care cost	$\bar{n}, cc$	0.005	0.8%
<b>Total</b>		0.654	100%

the model, the more explanatory variables contribute to the  $R^2$ -coefficient and the more relevant is a decomposition of  $R^2$  into its contributing variables. Second, the  $R^2$ -coefficient between the model's predictions and the actual data for the aggregate unemployment rate is quite high. Thus, the variation in the exogenous variables and parameters is highly informative about the cross-country variation in the aggregate unemployment rate.

### *Fiscal policy, union preferences, or households' taste for leisure?*

Is the cross-country variation in unemployment rates due to differences in union behaviour, household preferences or fiscal policy variables. Blanchard (2004) and Alesina *et al.* (2005) emphasize the role of union behaviour and differences in the taste for leisure of households. Other authors such as Prescott, 2004, Ohanian *et al.*, 2008 and Dhont and Heylen (2008) conclude that differences in fiscal policy are superior. Looking at Table 4, the conclusion is that both fiscal policy variables and union preferences and wage setting matter. They account each for about half of the unemployment variation across countries. A correct diagnosis of the unemployment problem and analysis of cross-country differences clearly seems to require both components. On the other hand, any differences in households' taste for leisure can safely be ignored. Integrating these findings, our interpretation is that while the above market-clearing wage chosen by the unions is the source of unemployment, the fiscal policy variables explain a

large part of the magnitude of the unemployment rate.

If we explore the impact of the union parameters into more detail, we notice that the contribution of the variation in  $\chi_j^R$  (i.e. the relative weight on wages as opposed to employment for age group  $j$ ) is superior to that of the variation in  $\rho_1^R$  and  $\rho_2^R$  (i.e. the weights in the specification for the reference wage of the unions).

Looking at the different components of fiscal policy, a surprising result is that - despite huge cross-country variation in  $\xi$ ,  $\Gamma$ ,  $\tau^p$ , and  $\tau_c$  - these tax rates and parameters have no role to play when it comes to explaining unemployment differences across countries. Countries with higher average tax rates and a higher degree of progressivity in labour taxes are not necessarily the countries with the highest aggregate unemployment rate. Ambiguous effects from higher taxes may explain this. A rise in  $\tau^p$  for example will imply higher unemployment because it raises the cost of low skilled labour for the firms. On the other hand, it also generates effects that may lead to lower unemployment. One is the negative effect of a rise in  $\tau^p$  on competitive gross wages, which will imply more moderate wage claims from the unions. Another is that higher taxes may feed through into higher lump sum transfers in our model. The negative effect of higher transfers on the supply of hours per worker will induce firms to hire more people. Similar ambiguity follows after a rise in  $\Gamma$ . On the one hand, this negatively affects labour supply, pushing wages up and making low skilled workers more expensive. Firms will then hire fewer workers, and unemployment rises. On the other hand, the fact that individuals supply fewer hours because of higher taxes (and an expected increase of lump sum transfers), will induce firms to hire more people.

The major role of the replacement rate  $\tilde{b}_j$  is not a surprising result, however. From the results of the calibration in Table 3, it is clear that unions in both continental Europe and Nordic countries attach a positive weight  $\rho_3^R$  to the level of these benefits. This weight is the largest in continental Europe. Benefit changes will therefore affect the cost of low educated labour most in these countries, and therefore firms' willingness to hire. Important differences in benefits as exist for example between France and Germany can then be expected to explain a significant fraction of unemployment differences in the period studied. The contribution of  $\tilde{b}_j$  might even be an underestimation, as it is the combined impact of the net replacement rate and the region-



specific union preferences that drive the Shapley results for the union preferences.

The variation in the capital tax rate has a small positive contribution to the  $R^2$ . Its influence runs via the first order condition of the firm with respect to capital, and has an impact on the variation in labour demand over countries. This effect dominates the indirect effect on the lump sum transfers. Thus, a decrease in  $\tau_k$  leads to a decrease in unemployment due to the higher labour demand. Government spending affects unemployment via the lump sum transfers. An increase of  $g$  leads to a decrease in lump sum transfers. Households will consume less and supply more hours. Therefore, the firm will hire fewer individuals (unemployment increases).

## VII. Conclusion

Huge differences in labour market performance across OECD countries have attracted the attention of many researchers during the last decade. One strand of the literature has emphasized the major role of the composition of fiscal policy, i.e. the level and structure of taxes and government expenditures (Prescott, 2004; Rogerson, 2007; Dhont and Heylen, 2008; Wallenius, 2013; Alonso-Ortiz, 2014). The focus of these studies is mainly on explaining employment (hours worked). All assume perfect competition and as such disregard any role for labour market imperfections. Unemployment is not an issue in these studies. A second tradition in the literature also recognizes the role of labour taxes and unemployment benefits, but this tradition has put much more emphasis on the role of unions (e.g. union power and wage bargaining) and labour and product market institutions (Daveri and Tabellini, 2000; Nickell *et al.*, 2005; Alesina *et al.*, 2005). Last but not least, some other authors (e.g. Blanchard, 2004) have pointed to the key role of household preferences. In their view, a major element behind the weaker employment performance in many European countries compared to the US is a higher taste for leisure in Europe. Alesina *et al.* (2005) explain that stronger unions may have contributed to this higher taste for leisure in Europe.

This paper is complementary to the first strand of the literature. We also develop a general equilibrium model (OLG model) to study cross-country differences in labour market performance. While we somewhat simplify the approach by assuming exogenous participation, our main contribution is to extend this literature so that it can also explain equilibrium unemploy-

ment among lower educated individuals. This extension is important given that differences in employment rates among OECD countries are strongly related to countries' success or failure in avoiding unemployment among the lower educated. Two assumptions are key in our model. The first one is the assumption that individuals are heterogeneous by ability. They enter the model with different human capital stocks and have different capacity to build more human capital. A second assumption and key novelty compared to previous work in this tradition is the assumption of a unionized labour market and union wage setting for lower ability (lower educated) individuals. For higher ability individuals we assume that wages and employment are determined in a perfectly competitive way.

Calibrating and simulating this richer model for twelve OECD countries, we are able to assess the relative importance of a whole range of explanatory variables for cross-country differences in unemployment. Performing a Shapley decomposition we find an almost equal role for differences in fiscal policy variables and in union preferences. Each account for about half of the cross-country variation in unemployment rates explained by our model. By contrast, any differences in the households' taste for leisure play no role. Integrating our findings, our interpretation will then be that the above market-clearing wage chosen by the unions is the source of unemployment, while the fiscal policy variables explain the major share of its magnitude. Going into greater detail on the fiscal side, we find that differences in unemployment benefit generosity play a much more important role than tax differences. In the Nordic countries and (even more) the continental European countries, the unemployment benefit replacement rate has a significant impact on union wage setting.

Our results highlight the relevance of integrating heterogeneity in individuals' ability and labour market imperfections into dynamic general equilibrium analyses of labour market performance. Imposing perfect competition seems to imply that an important fraction of reality is unfortunately ignored. By contrast, cross-country differences in households' taste for leisure seem insignificant for unemployment, and can safely be disregarded.

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